Relief on Long-Duration Insurance Transition

The implementation date for the overhaul of long-duration insurance accounting is quickly approaching for large SEC registrants. Accounting Standards Update (ASU) 2018-12, Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI), makes targeted—but significant—changes to assumption updates, amortization of deferred acquisition costs, and accounting for market-risk benefits and adds extensive new disclosures. On December 15, 2022, FASB issued ASU 2022-05 to provide optional transition relief, which will be effective with the adoption of ASU 2018-12.

ASU 2018-12
(as amended)

SEC Filers, Not SRCs
Annual and interim periods beginning after December 15, 2022

All Others
Fiscal years beginning after December 15, 2024; interim periods beginning after December 15, 2025

For a detailed review of the upcoming changes, see our **FORsights**™ article, "What You Need to Know: Long-Duration Insurance Changes." Insurers that only issue statutory-basis financials are not impacted by ASU 2018-12.

Background

ASU 2018-12 requires a retrospective transition as of the beginning of the earliest period presented or the beginning of the prior fiscal year if early application is elected. As large insurers continue implementation efforts, they highlighted that applying the LDTI guidance to contracts that were derecognized because of a sale or disposal before the LDTI effective date would not provide decision-useful information to financial statement users and would cause significant operability challenges in implementing the guidance.

Transition Relief

ASU 2022-05 creates an optional, transaction-by-transaction accounting policy election whereby an insurer could opt out of applying ASU 2018-12 to certain contracts or legal entities sold before the effective date if they meet both of the following criteria:

- The contracts have been derecognized because of a sale or disposal. The sale or disposal may be on an individual contract basis, a group basis, or a legal entity basis. Recaptures and contracts that are derecognized because of early termination are not within the scope of the accounting policy election.
- The insurance entity has no significant continuing involvement with the derecognized contracts.

The ASU includes the following forms of significant continuing involvement that would prohibit an insurance entity from applying the accounting policy election:

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- An interest that provides **significant influence**[1] over the derecognized contracts
- Any other arrangement that allows for significant participation in the derecognized contracts

The following are examples that would not be considered significant continuing involvement and would allow an insurance entity to apply the accounting policy election:

- Investment management, policy servicing, or other administrative arrangements
- Standard merger and acquisition representations and warranties

These amendments are not intended to be analogized beyond this ASU.

Disclosures

An entity would be required to disclose if the accounting policy election was made and a qualitative description of the sale or disposal to which the election was applied.

Disclosure of the gain or loss on contracts derecognized because of a sale or disposal before the LDTI effective date is not required as part of this ASU because existing guidance already requires that gains or losses on the sale or disposal transaction be disclosed if not separately presented on the face of financial statements.

Transition & Effective Date

These updates in ASU 2022-05 should be adopted concurrently with ASU 2018-12.

SEC Insights

At the December 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments, Craig Olinger, senior advisor to the chief accountant of the SEC's Division of Corporation Finance, discussed transition date reporting implications of LDTI transition.

For most domestic registrants, ASU 2018-12 is effective as of January 1, 2023 and the transition date is January 1, 2021. The requirement to retrospectively revise the annual financial statements in a new registration statement would not cause the transition date of ASU 2018-12 to change from January 1, 2021, to January 1, 2020.

Consider a calendar-year-end domestic registrant that adopts LDTI on January 1, 2023 with a transition date of January 1, 2021. In May 2023, the registrant files its first-quarter Form 10-Q, which reflects the adoption of the new standard for all periods presented. The next month, the registrant files a new registration statement on Form S-3 that incorporates by reference the registrant's Form 10-Q that includes its interim financial statements for the quarters ending March 31, 2023 and 2022, along with the Form 10-K that includes its annual financial statements for the years ending December 31, 2022, 2021, and 2020. In this scenario, although the annual financial statements for 2022 and 2021 would need to be retrospectively revised to reflect the adoption, the registrant would not need to change the transition date of the accounting

[1] To determine whether significant influence exists, an insurance entity shall consider the guidance in Accounting Standards Codification (ASC) 323, Investments—Equity Method and Joint Ventures. See Appendix.

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standard from 2021 to 2020 and the 2020 financial statements would not need to be retrospectively revised. However, the timing of the retrospective revisions would be accelerated as a result of the inclusion of these financial statements in the registration statement.

For domestic registrants, the concept of a fundamental change under Regulation S-K, Item 512(a)(1), still applies to already effective shelf registration statements in the determination of whether a post-effective amendment to include retrospectively revised financial statements for 2022 (and 2021 for domestic registrants) would be triggered. In the absence of a fundamental change, retrospective application would not be required for a domestic registrant.

When a registrant is required to retrospectively adjust its previously issued financial statements in connection with a new or amended registration statement, it also must consider updating other affected financial information that it previously included in its Form 10-K, such as management's discussion and analysis and selected quarterly financial information.

Planning Considerations

Do not underestimate the time and effort in LDTI implementation. Significant decisions and work plans should include—but are not limited—to the following:

- Accounting policy and actuarial methodology
- Data inputs – Sourcing, storage, and infrastructure
- Cohort level
- Cross-functional coordination between actuarial, finance, accounting, and IT
- Valuation modeling
- Reporting both internal and external and any related restatements
- Testing and number of parallel runs
- Process, controls, and automation
- Stakeholder communications – In September, Lincoln Financial Group released a 13-page slide deck on implementation impacts, including impacts on book value, earnings, hedge costs, and capital generation
- Increased earnings volatility and hedging strategy
- Opportunities for modernization and process redesign
- Challenges – Resource constraints
- Impacts on reinsurance
- New non-GAAP measures and key performance indicators

Conclusion

LDTI will significantly change current practice, and insurers will need to change how they monitor and gather data. In addition, due to the unlocking of assumptions, income statement volatility will increase. Comparability between insurers will increase due to the elimination of certain measurement models and new disclosures. The effect on each insurer will depend on product mix, current accounting practice, and reporting requirements. This is likely to require extensive updates to systems, processes, and internal controls required to comply with the new guidance.

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For more information, visit forvis.com.

Contributors

Matt Church
National Industry Leader
matt.church@forvis.com

Jim Garner
Managing Director
jim.garner@forvis.com

Anne Coughlan
Director
anne.coughlan@forvis.com

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Appendix – Significant Influence (ASC 323-10-15-6 to 11)

The ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

- Representation on the board of directors
- Participation in policymaking processes
- Material intra-entity transactions
- Interchange of managerial personnel
- Technological dependency
- Extent of ownership by an investor in relation to the concentration of other shareholdings (but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor)

Determining the ability of an investor to exercise significant influence is not always clear and applying judgment is necessary to assess the status of each investment.

An investment (direct or indirect) of 20% or more of the voting stock of an investee shall lead to a presumption that in the absence of predominant evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee shall lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. The equity method shall not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in paragraph 323-10-25-2 would apply to investments other than those in subsidiaries.

An investor's voting stock interest in an investee shall be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges that may become available to holders of securities of an investee shall be disregarded.

Evidence that an investor owning 20% or more of an investee’s voting stock may be unable to exercise significant influence over the investee's operating and financial policies requires an evaluation of all the investment’s facts and circumstances. The presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies stands until overcome by predominant evidence to the contrary. Indicators that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include the following:

- Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence
- The investor and investee sign an agreement (such as a standstill agreement) under which the investor surrenders significant rights as a shareholder
- Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor
- The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders, tries to obtain that information, and fails
- The investor tries and fails to obtain representation on the investee's board of directors

The list is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. However, if any of these or similar circumstances exist, an investor with ownership of 20% or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant

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influence over the investee's operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

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